January 20, 2023 - (No. 1)

Cautiously optimistic that caution wins the day

By Taylor Schleich

It's a new year but it feels like nothing has changed when it comes to the Bank of Canada policy outlook. Once again, we find ourselves with no unanimous consensus from economists or markets on what the central bank will opt for. The BoC's new data dependent guidance ended up muddying the water even more given that we've seen strength in some corners of the economy (labour markets) and weakness in others (housing, business sentiment). Importantly, the intervening period since December's meeting has, on balance, been positive from an inflation normalization perspective. The billion-dollar question is: Is inflation normalizing quickly enough? We think it is and we are *very* cautiously optimistic they'll agree. As such, we are officially forecasting a 'no change' decision but we are not dismissing that there are valid reasons to expect the BoC to pull the trigger.

The Bank's December guidance said they'd "be considering" whether the policy rate needed to rise further by assessing "how tighter monetary policy is working to slow demand, how supply challenges are resolving, and how inflation and inflation expectations are responding". Let's go through their checklist.

Demand is certainly softening. Canadian housing is in recession with cumulative price declines now exceeding what was observed in 2008-09. But even more broadly, the latest BOS and CSCE also showed businesses and consumers are generally becoming more cautious/pessimistic. And just this morning, we learned core retail sales posted its largest monthly drop in 11 months in November. With monetary policy unequivocally restrictive, sentiment shouldn't improve anytime soon, even without further rate increases. Yes, lower bond yields will increasingly be reflected in fixed mortgage rates, but that's unlikely to spur another housing bull market, especially with potentially more restrictive macroprudential regulations in the pipeline. This sluggish near-term outlook is reflected in our growth forecasts and will be evident in the BoC's new MPR projections too.

Table 1: Inflation tracking slower than the BoC had thought

NBF and BoC forecasts for real GDP and CPI inflation

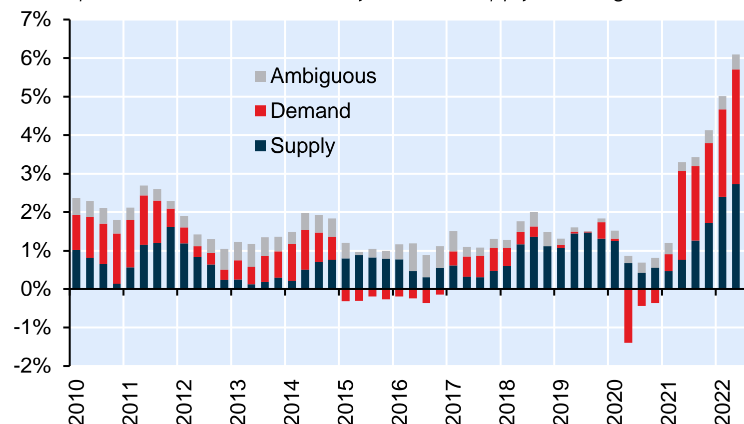
	Projection source	Q3	Q4	Q1	2023	2024
Real GDP	July MPR	3.9	-	-	1.8	2.4
	October MPR	3.6	2.1	-	0.9	2.0
	NBF/Actual	2.9	0.6	0.0	0.7	1.5
CPI inflation	July MPR	8.0	-	-	4.6	2.3
	October MPR	7.2	7.1	-	4.1	2.2
	NBF/Actual	7.2	6.7	5.0	2.9	2.2

Source: NBF, Bank of Canada | All figures are Y/Y except for quarterly GDP which is Q/Q. GDP figures are SAAR. NBF Forecasts subject to change in our Feb. Economic Monitor.

Supply challenges have gotten a lot of attention but, to us, are still an underappreciated contributor to price pressures over the last year. More than half of today's annual *PCE* inflation rate can be attributed to supply-side factors (Chart 1). These issues are quickly abating, which will help inflation melt away over the coming months. Relief is increasingly reflected in global shipping costs, commodity prices and any number of measures related to previously clogged supply chains. This was also borne out in this week's Business Outlook Survey which showed fewer businesses reporting supply constraints.

Chart 1: Inflation remains largely supply-driven

Decomposition of annual inflation by demand, supply or ambiguous drivers

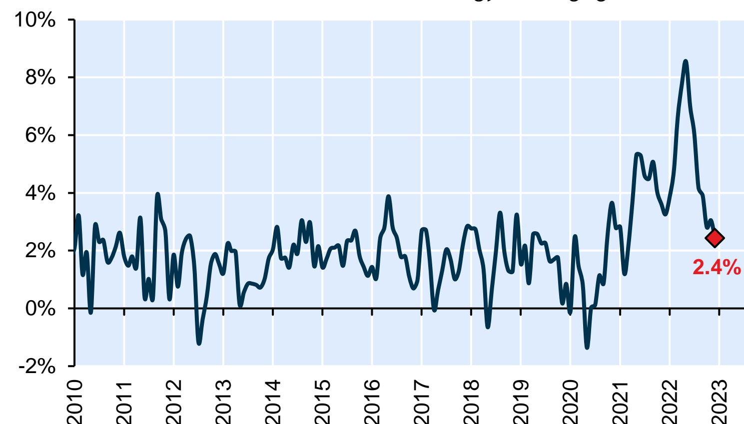


Source: NBF, StatCan

How about the most important item; inflation? Despite a 6.3% annual rate, price pressures are very clearly coming off the boil with momentum in core inflation halving from mid-2022. Ironically, the BoC's rate hikes have contributed to today's above-target inflation rates via higher mortgage interest costs. Exclude this item—a function of BoC rate increases—and you'll find core inflation ran at roughly 2.5% in Q4. With massive monthly increases from the first half of 2022 set to drop out from the annual calculation, we see price pressures at or *very* near target in Q3. And that's assuming there are no further rate increases. For the BoC, inflation has been coming in lower than they'd expected back in October. An updated MPR will usher in a more tepid inflation profile which shouldn't argue for *more* rate hikes than had been priced three months ago. A modest appreciation in the Canadian dollar over the past three months might alleviate some imported inflation concerns too (though it's a bit of a circular argument given the rate expectation-currency linkages).

Chart 2: Annual inflation is overstating underlying pressures

3-month annualized CPI inflation: Ex-food, energy & mortgage interest costs

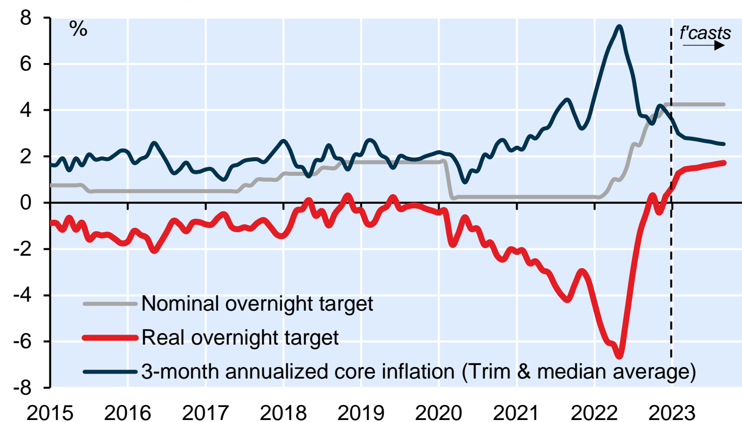


Source: NBF, StatCan

It's also instructive to consider the real policy rate. With the latest rate hikes and moderating inflation prints, policy is now back to where it was before COVID in *real terms* (roughly 0%, based on 3M annualized core inflation). No, that might not be exceptionally restrictive now but over the course of the year, receding price pressures will push the real policy setting higher even without any additional tightening. As soon

as March we could be looking at a 1%+ real policy rate. That's far more restrictive than any time in the pre-COVID years. And don't forget about the BoC's QT program set to pick up steam this year.

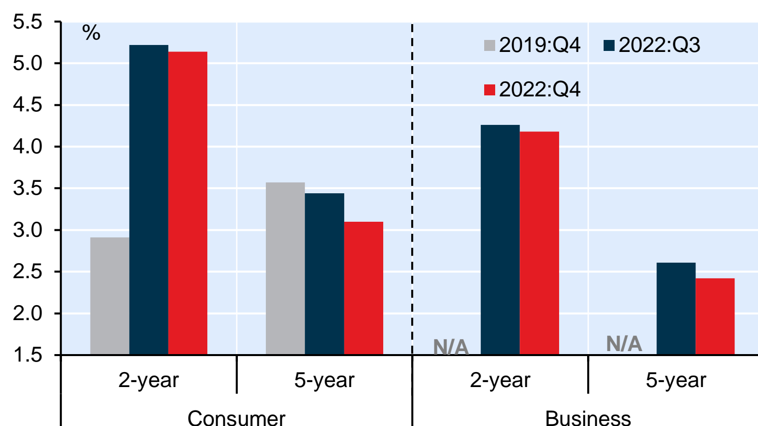
Chart 3: Even without more hikes, policy to continue tightening
BoC overnight target: Nominal & real (based on 3M annualized core inflation)



Source: NBF, Bloomberg, StatCan

We will concede that inflation expectations, as per the BOS, don't scream for a pause. The 2-year outlook from Canadian firms barely budged over the past three months. But we contend business' views on the inflation trajectory is subject to recency bias, skewed higher by the 2022 bout of above target price pressures. We assign little value to a 4.2% inflation expectation over the next two years especially when underlying price pressures aren't even that high now. BoC research has even shown that firms' inflation expectations aren't good predictors of realized inflation beyond a few months. What we do put more stock into is long-term expectations remaining anchored (for businesses and consumers, but more importantly financial markets). And we were also encouraged to learn that businesses are returning to or will soon return to pre-pandemic pricing practices.

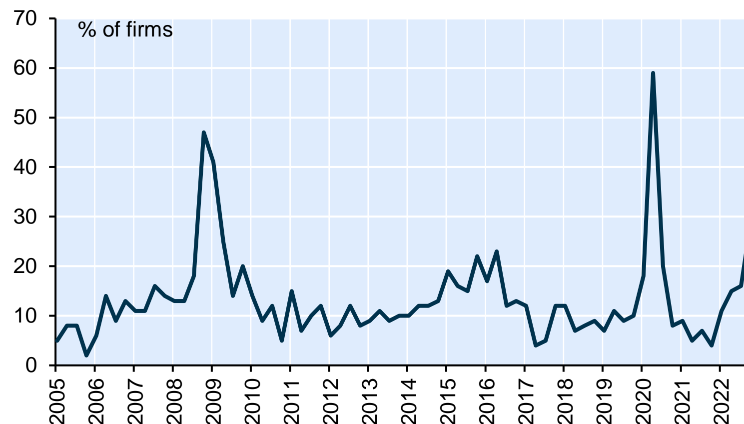
Chart 4: Yes, near-term inflation expectations are still hot
2- and 5-year inflation expectations for businesses and consumers



Source: NBF, Bank of Canada | Note: Business expectations not published pre-COVID

Lastly, it's worth speaking to the labour market, even if it isn't directly mentioned in the Bank's guidance. One might argue that tightness here will lead the BoC to hike given the Phillips-curve assumption that low inflation can't coexist with low unemployment. It is a somewhat compelling argument since we've heard policymakers conclude that creating labour market slack is the key to solving inflation (more so at the Fed, but also from Macklem). But our view is that employment is *not* a leading indicator. (An aside: Many leading indicators *are* flashing red and the central bank's commodity price index is already down 35% from its peak in Q2, pointing to a sharp erosion of Canada's terms of trade and yet another quarter of negative nominal GDP growth). Already-tight policy will slow labour demand, bringing it back into line with supply. Actually, that's already happening. Hiring intentions in the BOS are at/below 'normal' levels, with wage pressures now abating. And it's hard to imagine labour demand persisting when ~30% of Canadian firms expect sales to decline in 2023 (that was just 16% in the prior survey).

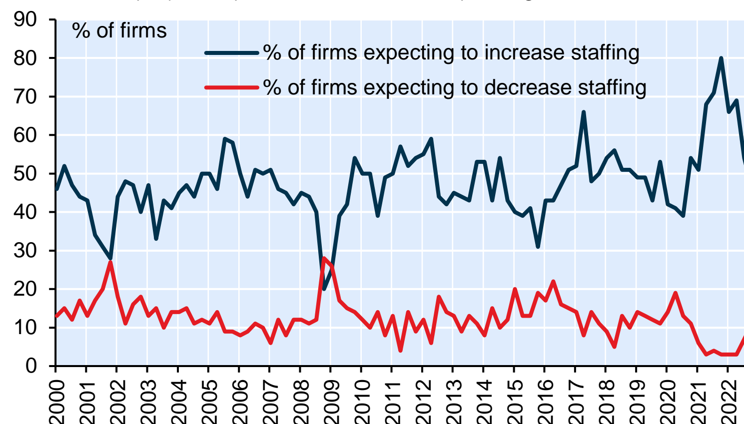
Chart 5: Do falling sales volume really require more labour?
% of firms expecting sales volumes to decline over the next 12 months



Source: NBF, Bank of Canada

The resilience in the jobs market to date combined with easing inflation should be celebrated as it means a soft-*ish* landing is in reach. It shouldn't mean that rate hikes continue until job losses begin. For a central bank that now (loosely) incorporates employment, this should be taken into consideration.

Chart 6: Slower hiring & limited layoffs: This is a good thing!
12-month employment plans: Share of firms expecting to add/decrease staff



Source: NBF, Bank of Canada

Bottom Line: On balance, we believe the case for caution/remaining sidelined is more compelling. We're cautiously optimistic that the BoC will see things similarly, but we concede both camps have valid reasons for their forecasts. Whether or not the Bank opts to hike next Wednesday, we have far more conviction that the March meeting will result in a 'hold'. Having been burned providing more definitive guidance in the past few years, this might not be explicitly stated. A tinge of data dependence is likely to be retained but we could see the Bank introduce language to make the bar for additional hikes even higher. This may come via an acknowledgement of significant tightening to date and/or an explicit recognition of the lags with which policy operates.

Latest Policy Statement – December 7, 2022

Bank of Canada increases policy interest rate by 50 basis points, continues quantitative tightening

The Bank of Canada today increased its target for the overnight rate to 4¼%, with the Bank Rate at 4½% and the deposit rate at 4¼%. The Bank is also continuing its policy of quantitative tightening.

Inflation around the world remains high and broadly based. Global economic growth is slowing, although it is proving more resilient than was expected at the time of the October Monetary Policy Report (MPR). In the United States, the economy is weakening but consumption continues to be solid and the labour market remains overheated. The gradual easing of global supply bottlenecks continues, although further progress could be disrupted by geopolitical events.

In Canada, GDP growth in the third quarter was stronger than expected, and the economy continued to operate in excess demand. Canada's labour market remains tight, with unemployment near historic lows. While commodity exports have been strong, there is growing evidence that tighter monetary policy is restraining domestic demand: consumption moderated in the third quarter, and housing market activity continues to decline. Overall, the data since the October MPR support the Bank's outlook that growth will essentially stall through the end of this year and the first half of next year.

CPI inflation remained at 6.9% in October, with many of the goods and services Canadians regularly buy showing large price increases. Measures of core inflation remain around 5%. Three-month rates of change in core inflation have come down, an early indicator that price pressures may be losing momentum. However, inflation is still too high and short-term inflation expectations remain elevated. The longer that consumers and businesses expect inflation to be above the target, the greater the risk that elevated inflation becomes entrenched.

Looking ahead, Governing Council will be considering whether the policy interest rate needs to rise further to bring supply and demand back into balance and return inflation to target. Governing Council continues to assess how tighter monetary policy is working to slow demand, how supply challenges are resolving, and how inflation and inflation expectations are responding. Quantitative tightening is complementing increases in the policy rate. We are resolute in our commitment to achieving the 2% inflation target and restoring price stability for Canadians.

Information note

The next scheduled date for announcing the overnight rate target is January 25, 2023. The Bank will publish its next full outlook for the economy and inflation, including risks to the projection, in the MPR at the same time.

Source: Bank of Canada

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